Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	
	)	
Treatment of Operator Services	)	CC Docket No. 93-124
Under Price Cap Regulation	)	
	)	
Revisions to Price Cap Rules for AT&T	)	CC Docket No. 93-197

REPLY OF U S WEST COMMUNICATIONS, INC.

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January 11, 1996

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I. INTRODUCTION AND SUMMARY

As the variety and number of parties filing comments on the Second NPRM in this proceeding[1] demonstrate, competition in the local exchange marketplace has arrived and is increasing rapidly.[2] Numerous commentors in this round either did

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[1] In the Matter of Price Cap Performance Review for Local Exchange Carriers, Treatment of Operator Services Under Price Cap Regulation, Revisions to Price Cap Rules for AT&T, CC Docket Nos. 94-1, 93-124, 93-197, Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393, rel. Sep. 20, 1995 ("Second NPRM"). See also Order on Motion for Extension of Time, DA 95-2340, rel. Nov. 13, 1995.

[2] Comments were filed by Ad Hoc Telecommunications Users Committee; Ameritech; Association for Local Telecommunications Services ("ALTS"); AT&T Corp. ("AT&T"); Bell Atlantic Telephone Companies; BellSouth Telecommunications, Inc.; California Cable Television Association; Cincinnati Bell Telephone Company; Comcast Corporation ("Comcast"); Competitive Telecommunications Association ("CompTel"); Cox Enterprises, Inc. ("Cox"); General Services Administration ("GSA"); GTE Service Corporation; ICG Access Services, Inc.; Information Industry Association; LCI International, Inc.; WorldCom, Inc., d/b/a LDDS WorldCom; MCI Telecommunications Corporation ("MCI"); MFS Communications Company, Inc. ("MFS"); National Cable Television Association, Inc. ("NCTA"); New York State Department of Public Service; NYNEX Telephone Companies; Pacific Bell and Nevada Bell; Southern New England Telephone Company; Southwestern Bell Telephone Company; Sprint

not exist when price caps were implemented in 1990 or did not care. They obviously care now. As expected in a competitive proceeding, the comments are polarized. The price cap local exchange carriers ("LEC") strongly support access reform and pricing flexibility measures which would allow them to compete on an equal basis in the marketplace; the new entrants -- including some that are not so new to the telecommunications marketplace -- strongly oppose such freedoms. No stronger case could be made that competition has arrived than through a review of the vehement objections raised by commentors attempting to gain competitive leverage in the marketplace. A thousand pie charts could not have the same impact.

As would be expected, non-LEC commentors opposed further pricing flexibility and other positive regulatory reform measures for price cap LECs. Obviously, their agenda is not pro-competitive. Quite the contrary, they understand that a competitive advantage can be gained by stalling legitimate LEC regulatory freedoms for as long as possible. Comments opposing additional regulatory flexibility represent a clear attempt to continue to hamstring U S WEST and other local telephone companies through the perpetuation of existing regulatory disparity. As demonstrated by the vehement opposition to the Federal Communications Commission's ("Commission") Second NPRM proposals which afford something closer to fair competition, continuing the current regulatory

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Corporation ("Sprint"); Sprint Telecommunications Venture ("STV"); Telecommunications Resellers Association; Teleport Communications Group Inc. ("Teleport"); The Information Technology and Telecommunications Association; Time Warner Communications Holdings, Inc. ("Time Warner"); United States Telephone Association ("USTA"); and U S WEST Communications, Inc ("U S WEST").

disparity obviously provides substantial economic and marketing benefits for LEC competitors' current and planned entry into the local exchange marketplace.

ALTS had the chutzpah to claim that even inefficient competitive entry actually provides a benefit to consumers.[3] While this position would be questionable even where there was pure market-based pricing, it is certainly not valid in the subsidy-rife world of regulated telecommunications. In the case of local telecommunications, rate-paying customers in effect fund a competitor's inefficient entry into subsidy-created, high-margin segments of the telecommunications business through the implicit and explicit subsidies included in various telephone rates. Whereas all of the dollars from these high-margin segments previously flowed into subsidized portions of the phone business -- to keep rural and residential prices below their embedded costs -- these dollars now also flow into the pockets of providers who leverage the subsidy-created rate disparities. These companies do not have universal service obligations nor are there any social expectations that they will ensure end-to-end connectivity with advanced networks. This rate-leveraging practice actually harms customers who end up not only subsidizing the high-cost segments of the phone business, but also the earnings of providers which are unfettered by social compact obligations.

Sprint correctly notes in its Comments that the current access charge rules produce many detrimental consequences.[4] To summarize, Sprint states that

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[3] ALTS at iii, 10.

[4] Sprint at 5.

interexchange carriers ("IXC") must either pay the subsidy-enlarged rates to the LECs or succumb to artificial incentives to engage in service or facilities bypass; LECs are limited in their abilities to respond fairly and effectively to competitive pressures; and competitive access providers ("CAP") receive incorrect signals about the long-term economic feasibility of entering the access and local exchange markets.[5] These access charge rules and other historical monopoly-based regulatory policies have distorted the economic realities of the current local exchange marketplace. In a letter to the Wall Street Journal titled "A Free Ticket to the Rich Telecom Markets," Professor Alfred E. Kahn has concisely summarized this current regulatory disparity and also responded to the inconsistent and disingenuous resale pricing arguments raised by AT&T. "What AT&T is demanding is an equal shot at the overpriced markets without having to bear any of the costs that justify that overpricing."[6] Attached hereto as Exhibit 1 is a copy of that letter.

U S WEST believes that increased competition with regulatory parity will provide substantial benefits to customers through market-based interstate access prices and greater efficiencies. Competition is already appearing in many areas and will increase even more when the local service plans of AT&T and others are implemented.[7] It is imperative, however, that the Commission act now to increase

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[5] Id.

[6] Wall Street Journal, Letter to the Editor from Alfred E. Kahn, Professor Emeritus, Cornell University, "A Free Ticket to Rich Telecom Markets" (Nov. 10, 1995).

[7] See Statement of AT&T Chairman Robert E. Allen, as quoted by the Wall Street Journal, "AT&T Vows Battle to Offer Local Service" (Oct. 27, 1995) ("We will fight for our right to give our customers

the pricing flexibility of the LECs through the proposals included in the Second NPRM. A short transition period exists for the Commission to take the necessary steps to build upon the productive regulatory model it created with the introduction of price caps. U S WEST reiterates its support for measures which would:

- Eliminate the Part 69 waiver process for switched access services.
- Provide alternative pricing plans, including volume and term discounts for switched access.
- Provide additional pricing flexibilities, including metropolitan statistical area ("MSA")-wide zones for switching, carrier common line ("CCL"), and the residual interconnection charge.
- Not condition such pricing flexibility on a competitive showing.
- Revise baskets and reduce the number of service categories.
- Establish definite criteria and time frames for Commission action and regulatory parity.
- Define an MSA as the relevant market area for the application of streamlined regulation.
- Allow the use of contract carriage to respond to generally issued Requests for Proposals ("RFP").

These proposals, along with additional access reform, will allow the telecommunications marketplace to flourish with the parity necessary to foster increased competition.

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a choice for local service through every option open to us. . . . That includes reselling local services, using alternative providers, and building our own telephone network facilities.").

II. BASELINE MODIFICATIONS ARE REQUIRED NOW AND DO NOT REQUIRE ADDITIONAL COMPETITIVE SHOWINGS

Many parties opposing immediate baseline modifications to the Commission's price cap rules cite the lack of existing competition as the reason for their position. U S WEST notes that 18 parties, representing current and future direct competition to the incumbent LECs, filed comments in this proceeding. None of the parties included is a small player in the telecommunications industry. The roster of filing parties includes: 1) large IXCs or their associations (e.g., AT&T, MCI, Sprint, CompTel, etc.); 2) large cable television operators or their associations (e.g., Time Warner, Cox, Comcast, NCTA, etc.); and 3) well-established CAPs or their associations (e.g., Teleport, MFS, ALTS, etc.). As time passes, however, it will be impossible to distinguish the services offered by CAPs from those offered by IXCs or competitive local exchange carriers. These entities are expected to spend billions of dollars for entry into businesses that will provide an entire array of telecommunications services in the next few years. Many of them have already spent billions of dollars on wireless personal communications licenses and associated technology. Under what other system could multi-billion dollar companies marshal these types of resources for entry in a so-called new market segment and still act as if they needed protection and nurturing from a regulatory body? And where else could these same entities claim, with a straight face, that competition was not yet relevant in the marketplace?

The position of AT&T and MCI asking the Commission to reject any further pricing flexibility for U S WEST and other LECs is akin to McDonald's asking a regulatory body for protection from Kentucky Fried Chicken for entry into the fried chicken market. Like McDonald's expanding its line of fast food products, AT&T and MCI will benefit in the local and national markets from: 1) established brand recognition; 2) established customer relations in complementary markets; 3) market data that will allow them to target profitable customers and market segments; 4) technical expertise in operating telecommunications networks; and 5) the potential for one-stop shopping. As is obvious from this example and from the time frames announced by AT&T and others for entry into local markets, the baseline modifications proposed by the Commission in the Second NPRM are necessary now. These modifications must be adopted to allow the LECs to remain competitive in this rapidly developing marketplace.

It should be fairly obvious that the arguments raised by LEC competitors are nothing more than an attempt to maintain their current regulatory advantage. As long as the current rules are in place, they will be able to maintain pricing and other market advantages. The current rules, however, do not provide for fair and open competition. Until the rules are changed, these companies will continue to leverage existing regulatory disparity to the detriment of customers and competitors alike.

U S WEST attached several exhibits to its Comments which demonstrate significant competitive entry in its region, and other LECs provided examples from

their specific regions and states. USTA notes in its filing that local competition is already allowed in 31 states.[8] CAPs are providing service in 41 states plus the District of Columbia.[9] In those 41 states, CAPs operate in 552 distinct areas, well beyond what would be considered the primary metropolitan areas; there are two or more CAPs operating in 252 of these areas; and current expansion plans call for the entry into 146 other localities and four additional states. Competition from wireless carriers is expected in many metropolitan areas within the next one to three years,[10] and cable operators have ordered more than half-a-million cable modems to provide data service in the near future.[11]

Since it is obvious that competition already exists, no further demonstration should be necessary or required for the Commission to adopt the baseline regulatory modifications it proposes. The widespread presence of competition, as discussed above, also makes it unnecessary to tie basic plan changes to some competitive criteria in a given area. The administrative and marketing burdens such an approach would impose on the LECs would far outweigh the potential advantages of any additional baseline flexibility. The Commission should reject the claims that

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[8] USTA at Attachment 3.

[9] Id. at Attachment 2.

[10] See Information Access Company Newsletter Database, Phillips Business Information, Inc., Wireless Business and Finance, Late-1995 Signposts Point Way Toward Industry Trends of 1996 ("'Our goal is to provide service in our own markets by the end of 1996,'" said Tom Mateer, Sprint Telecommunications Venture, "the largest of the A/B-block major trading area (MTA) Licensees in terms of potential market population. Other MTA Licensees, including AT&T Wireless Services and PCS PrimeCo L.P., are working against similar timetables.").

[11] See Cable World, Modem Mania in Anaheim, Alan Breznick and Carl Weinschenk (Dec. 4, 1995).

the additional flexibility will result in predatory pricing and other anti-competitive responses by the LECs. Similar predictions have been made previously and the disasters portended have not materialized. Competitors will still have a full array of remedies available to them for any anti-competitive behavior under various federal and state antitrust laws, the Communications Act, and the Commission's Rules. No parties have demonstrated that the proposed changes would give price cap LECs any true leverage with regard to the markets as they exist today. Price cap rules would still limit the ability to raise prices and any potential for cross-subsidization.

III. A COMMISSION IMPOSED CHECKLIST FOR ADDITIONAL REGULATORY FLEXIBILITY IS INAPPROPRIATE

The proposals for relaxed regulatory treatment in the Second NPRM demonstrate the Commission's clear vision for the future of competitive telecommunications. As shown previously, these proposals for the baseline plan are appropriate without requiring LECs to meet any further competitive criteria. Competitive entry has already been enhanced by the Commission's Orders in the Expanded Interconnection and Local Transport Restructure dockets. Additional competitive criteria would not provide benefit to the interstate access marketplace and might be used by other parties to forestall beneficial competition.

None of the Commission's proposed baseline modifications changes the basic requirements for new service introductions. Many of the changes proposed simply modify the effective date of filings. All of the proposed modifications are in the

public interest as customers will get the benefit of market-based prices and the rapid introduction of new and innovative services. Furthermore, reduced cycle times and lower burdens for regulatory review make better use of both LEC and Commission personnel. LECs get the benefit of regulatory flexibility and simplified administration, and the Commission receives only the information it needs to evaluate truly new services. Tariffs are still filed with sufficient notice periods, and opportunities for comment and adjudication of complaints are still available.

Additional barriers required for the use of these improved regulatory processes are contrary to the whole notion of this proceeding -- easing restrictions while promoting innovation, efficiency, and increased competition. The Commission should choose to offer such flexibility without imposing additional regulatory burdens.

Meeting the requirements of a checklist also raises the potential for competitors to bog down the process and keep an incumbent from effectively responding to competition. An onerous level of detail and subjective competitive measurements create the potential for endless debate in perpetual dockets.

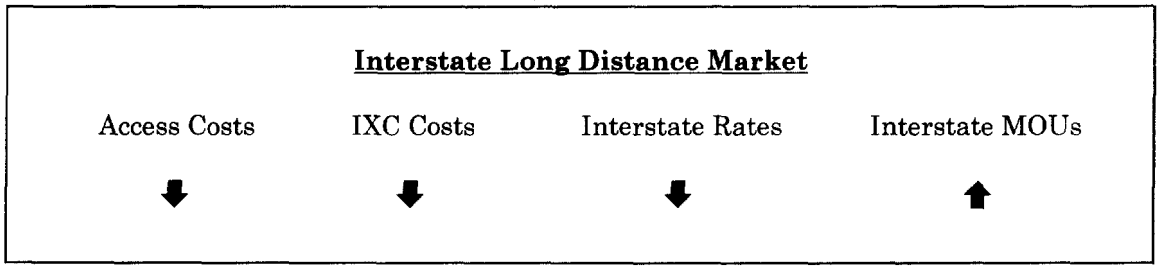
IV. A MARKET SHARE SHOWING IS EVEN MORE INAPPROPRIATE

A market share showing as suggested by several commentors, including AT&T and Time Warner, is even more inappropriate for the interstate access marketplace than is a competitive checklist.[12] Many parties point to the situation

[12] AT&T at 16-17; Time Warner at 7.

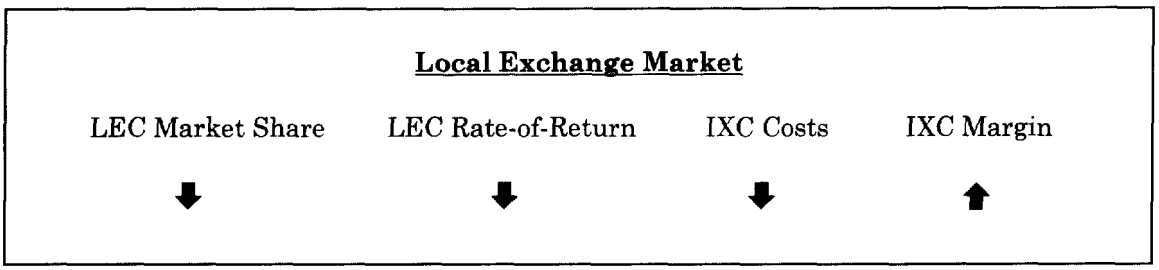
which occurred with AT&T and its competitors in the interexchange marketplace as an example of why a market-share test is appropriate for the LECs. As the Commission surely understands, the market dynamics of interstate access and interstate long distance are vastly different.

While AT&T did indeed lose significant market share to MCI and others, AT&T's market is not comparable to that of the price cap LECs. In the case of AT&T, LEC access charge reductions were required to be passed on to consumers through forced reductions in AT&T's rates which stimulated additional long distance minutes of use ("MOU"). The increase in average MOU, coupled with lower costs, offsets the loss in market share. AT&T's revenue continued to rise in spite of the loss in market share. In fact, the reduction in access costs fueled the entry of multiple interstate long distance competitors, creating a more robust interstate long distance market. As can be seen from the following chart, all parties benefited:



LECs do not have a similar opportunity for recouping lost market-share revenues. LECs' costs are embedded with no mechanism for reducing costs such as AT&T had from reduced access charges. Loss of market share for price cap LECs will equate to a direct loss of revenue with no comparable reduction in costs to offset

that loss. Nor do LECs have the ability to directly stimulate the interstate long distance market. The loss in LEC revenue without a concurrent reduction in costs will result in a drastic reduction in rate of return ("ROR"). A low ROR will impede the raising of capital necessary for LECs' future network investments. These network investments are required to support universal service obligations and to remain competitive. The following chart shows the situation faced by the LECs:



As is obvious, the impact on the LECs is negative and the impact on the IXCs is positive. The impact on consumers is not so clear since IXCs are not required to pass reductions in access charges on to consumers. Consumers are not likely to see immediate price changes. Another significant impact will be on the funds which flow to universal service.

To put these impacts into perspective, if U S WEST had to experience a 30% erosion in market share before it was granted pricing flexibility, it would experience approximately a $700 million loss in interstate revenues. For both intrastate and interstate combined, the revenue loss would be approximately $3 billion, most of which flows today to support universal service. This potential impact is obviously huge. As a carrier of last resort, U S WEST has significant universal service

responsibilities beyond that of its competitors or AT&T. A large revenue loss would severely impact future abilities to maintain this important public policy objective.

A significant revenue loss also would sharply reduce the LECs' ROR and, more importantly, the ability to generate cash or attract new capital from investors to maintain a state-of-the-art national telecommunications network -- a stated goal of the Commission. This serious financial impact is mainly a result of the inability of U S WEST or any LEC to directly drive increased MOU, resulting in higher revenues. Unlike the IXCs, the LECs do not have a large singular variable expense item, like access expense, to quickly reduce their costs. LECs' business growth is more closely tied to housing growth. On the other hand, a market-share loss test for incumbent LECs has the effect of guaranteeing a competitor's revenues and cash flow. Neither result is fair nor appropriate in a truly competitive marketplace.

V. THE RELEVANT PRODUCT MARKET FOR COMPETITION IS SERVICE CATEGORY AND THE RELEVANT GEOGRAPHIC MARKET IS THE MSA

As noted in its Comments, U S WEST supports the definition of relevant product market by Service Category within a Basket as proposed by the Commission.[13] The Service Categories were developed initially based on their fundamental relationships and consideration of cross-elasticity. It is important for the Commission to recognize, however, that the competition will not simply target one specific Service Category or market area. Competitive showings, therefore, may

[13] U S WEST Comments at 34.

be for more than one Service Category at a time, depending on the nature of the competition. AT&T has proposed the use of bundles of related services for relevant product markets. This structure is overly complex and unrealistic in the context of the price cap plan. U S WEST's proposal to use the Service Category recognizes that competition will generally not limit its offerings to one specific type of service offering in a given locality and is supported by other commentors.[14]

As for relevant geographic market, the Commission should select MSAs as the logical choice for identifying competitive market areas. The use of MSAs -- as opposed to wire centers, groups of wire centers, or zones -- will benefit customers by providing a definition that they better understand. The use of MSAs will also allow the Commission and the LECs to make cross-industry comparisons.

AT&T has suggested that the Commission examine each access component separately to define its relevant geographic market.[15] U S WEST submits that this would make the administration of the price cap plan and tariff filings extremely complex and confusing to customers. It would also create a huge lag that would effectively preclude U S WEST and other LECs from obtaining timely regulatory relief. A single geographic market should be selected for all services, and it should be representative of how competitors will choose to enter the market. An MSA best represents the relevant area for the offering of competitive services.

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[14] MCI at 31; Time Warner at 45.

[15] AT&T at 13.

AT&T has suggested that streamlined prices be averaged if broader geographic markets are selected by the Commission.[16] Averaging would not be appropriate since the purpose of streamlined regulation is to recognize competition and move to market-based pricing. Averaging would also perpetuate inappropriate price umbrellas and subsidies. The price cap rules will sufficiently safeguard the non-competitive areas, and market forces will do the same for competitive areas.

VI. IT IS NOT PREMATURE FOR THE COMMISSION TO CONSIDER CONDITIONS FOR ADOPTING STREAMLINED REGULATION AND NON-DOMINANT TREATMENT

Many parties opposed to granting the LECs additional pricing flexibility also oppose the Commission's proposal to establish procedures for LEC-streamlined regulation and non-dominant treatment.[17] These parties state that the time is not right for consideration of these measures as the incumbent LECs have not faced significant competition in their relevant markets.[18] They propose that the Commission simply put this notion on the back burner until sometime in the future. Again, it is not difficult to surmise the motivation of the competitive local exchange providers to delay consideration of such criteria. It would obviously reward them to push out the development of streamlined procedures at a time when the LECs are already facing significant competition. At some future time, they would throw up

[16] Id. at 15.

[17] See, e.g., AT&T at 5; Time Warner at 61; Sprint at 25; STV at 10-11; MCI at 33; CompTel at 39.

[18] Id.

additional roadblocks and possibly raise other arguments as to why the timing was equally inappropriate. The Commission should again reject these shallow attempts to impede the natural progression of improved price cap regulation.

The true extent of future competition cannot accurately be projected. As is obvious from the players and the amounts of money projected to be spent, the Commission is correct to assume that competition will soon explode. Commissioner Barrett has surmised that competition will react to market forces and will develop at a different pace in different areas.[19] U S WEST believes that this is correct and that any attempt to time the development of competition will likely fail. It is therefore imperative that procedures be developed now to adequately respond to competition as it arises. The framework for moving toward market-based pricing rather than regulatory control needs to be developed and put in place by the Commission in this proceeding.

The Commission faces no risks in establishing the framework and procedures for streamlined regulation and non-dominant treatment today. In fact, by proceeding to put these criteria in place now, it eliminates the possibility of further delays by parties who would prefer to keep the status quo. For them, the protection offered by the existing rules and regulatory disparity provides additional time for rate leveraging and profit maximization. Regulatory disparity currently provides them with guaranteed markets for as long as they can put off access reform modifications.

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[19] Second NPRM, attached comments of Commissioner Barrett.

As an independent commentor, GSA generally supports the Commission's proposals.[20] GSA recognizes that most of the proposals are currently justified without regard to other competitive criteria.[21] It notes that the additional flexibility has the dual advantage of allowing carriers to set prices closer to cost and providing ratepayers with greater options.[22] The GSA is also correct in acknowledging that the proposals reveal no instance where there is danger of the LECs abusing pricing power.[23] Finally, GSA notes that the rules for new services and Alternative Pricing Plans do not influence rate increases as they are initially kept out of the price cap baskets.[24] These independent observations should assist the Commission in reaching an objective decision in this proceeding.

Based on these facts, it should be obvious that the time is right for the Commission to consider and implement the proposed criteria for streamlined regulation and non-dominant status. U S WEST supports the addressability standard proposed in its Comments and the comments of several of the other LECs.[25] These standards provide a simple and measurable criteria for the determination of appropriate regulatory relaxations. In addition, weight should be

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[20] GSA at i.

[21] Id. at 4.

[22] Id. at 5.

[23] Id.

[24] Id.

[25] U S WEST Comments at 38.

given to the presence of multiple competitors or the demonstrated intentions (affirmative marketing, construction of facilities, etc.) of additional competitive entry.

It is important to recognize that competitive relief is appropriate prior to the full deployment of a competitor's facilities in a given market. Should the Commission wait too long to provide relaxed regulation for the incumbent, significant competitive harm may occur in the marketplace or inefficient deployment of competitive facilities may take place. Early recognition of competition is important to establish a fair and efficient marketplace.

VII. ACCESS REFORM MEASURES ARE ALSO ESSENTIAL

Additionally, the Commission needs to implement access reform. The implicit subsidies inherent in the current system (e.g., those found in CCL charges) provide the impetus for inefficient entry and competitive imbalance. It is imperative that access reform be accomplished along with the measures proposed by U S WEST in its Comments.[26] The Commission must allow increased pricing flexibility and undertake comprehensive access reform for the benefit of future competition and telephone consumers.

While additional access reform is important, the Commission should reject suggestions that it consolidate all access reform proceedings in the interest of completeness and efficiency. The only efficiency desired by the parties suggesting

[26] Id. at 4.

Commission can accomplish both matters on a timely basis in separate proceedings without the need for consolidation.

VIII. CONCLUSION

The variety and number of parties commenting in this proceeding demonstrate that competition in the local exchange marketplace has arrived and is growing rapidly. In these Reply Comments, U S WEST again demonstrates the immediate importance of pricing flexibility and access reform proposals raised by the Commission in its Second NPRM. The Commission should move quickly to implement the reforms proposed and also provide the additional regulatory relief requested by U S WEST in this proceeding.

Respectfully submitted,

U S WEST COMMUNICATIONS, INC.

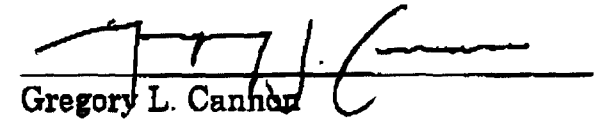
By: 

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Exhibit 1

Letters to the Editor

A Free Ticket to Rich Telecom Markets

Your news accounts of Oct. 24 and 27 have so far been doing a much more thorough job of representing the complaints of AT&T and a number of smaller companies that have been trying to break into the local telephone business than the position of the incumbent local exchange companies (the LECs)—the Baby Bells and others—with which they are trying to compete. Since I have in recent years represented the latter companies in some of the litigation over these issues, I am in a position to describe some of the counter-considerations your stories neglect. I shall do so as objectively as I can.

I have no light to shed on the merits of the many grievances by the would-be rivals described in the articles to the effect that "the local monopolies tie up newcomers in red tape and use inferior connections to retain their grip." But appraising the complaints that the LECs are trying to charge their challengers rates for use of all or part of their local networks so high as to make it impossible for them to compete (or to "resell" those basic services except at a loss) calls for understanding of some fundamental facts about the economics of the business and the regulatory policies to which it has been subject, on which the articles are silent.

The most important fact is the historical regulatory policy of setting rates for long-distance service and of basic exchange service to businesses in concentrated metropolitan areas—where the individual access lines are very short and the costs correspondingly low—far above cost in order to hold below cost the rates for basic residential service. The practice of regulators—universally, so far as I know—has been to require the telephone companies to price the latter service "residually," which means that the LECs have been under instructions to maximize the contributions above cost from the former two services in order to leave the smallest possible amount of total cost to be recovered in the basic residential charges. As a member of AT&T's first Economic Advisory Council, between 1968 and 1974, I well remember that company's perfectly valid arguments in favor of its retaining a monopoly of all telephone service in order to enable it to continue that cross-subsidization; in those protestations it had the fervent support of practically all the state regulatory commissions, which have wanted above all else to keep down those residential rates.

After AT&T was broken up—with the separation of the subsidy-generating long-distance business from the subsidy-requiring local business—the continued flow of subsidy was assured in two ways. First, the FCC permitted the local telephone companies—the Baby Bells and the others—to charge to long-distance companies prices far above cost for interconnection; that is, for enabling them to reach and be reached by placers and receivers of toll calls. And, second, the court was persuaded, largely by the state regulatory commissions, to retain for the Baby Bells a monopoly of the long-distance business within new, arbitrarily defined intrastate regions (the so-called "local access and transport areas" or LATAs), in which they have in consequence been able, with the support and approval of state regulators, to continue to charge prices outrageously above cost, in order to enable them to recover their total costs while continuing to suppress the politically sensitive basic residential rates.

Although there is some argument today about the extent to which those last rates remain below cost, the market itself provides the most conclusive evidence about which rates have been and remain far *above*: When competition came to the industry, it came first into the long-distance business (interLATA, after the AT&T breakup), then to providing direct access links between the long-distance carriers and businesses in center cities for originating and completing calls, in order to bypass the regulatorily prescribed overcharges by the LECs for those interconnections—every major metropolitan area in the country now has one of these competitive access providers—then in the provision of basic exchange services to businesses in those center cities and, now that the states have begun to let down the barriers, intra-LATA toll.

The core of the local monopoly (except for the competition of cellular) remains the ubiquitous network of wires outside of the cities running from the telephone company switches to every subscriber in the country: small wonder that remains a monopoly, considering the prices the phone companies are forced to charge for the service it makes possible. Unless and until it proves economic for the cable companies, which alone have a network of almost comparable ubiquitousness, or radio-based carriers to provide an alternative source of dialtone, there inevitably will be intense controversy over the rates at which the LECs lease those wires to carriers like AT&T, permitting them to "resell" those local lines into homes and businesses in order to be in a position to provide a complete package of local and long-distance services.

AT&T's complaint that, for example, the wholesale rate that the Southern New England Telephone Company (SNET) proposes to charge it for those customer lines, while markedly below the retail price for a business line, is far above the current retail rate—that is, the basic telephone charge—for a residential customer. How, AT&T complains, can it be expected to compete in the latter market?

But the facts it cites should have been the tip-off: How can a uniform wholesale charge for the line at one and the same time be comfortably below the basic monthly charge for service to business customers and above the charge to residential customers? The obvious reason is that the latter rate is below cost and the former above cost. So AT&T's deceptively reasonable complaint, "Why shouldn't the Baby Bells be forced to lease their customer loops to us at prices low enough so that we will be able to compete with them in signing up residential subscribers?" comes down to a demand for the same subsidies as those companies are forced by regulators to offer their residential customers: subsidies that they have been able to offer only by charging rates far above cost, with the approval of those same regulators, for toll service and for connecting long-distance carriers like AT&T with their networks.

Obviously, AT&T is not interested in providing basic residential dial tone for its own sake; and the economic feasibility of its doing so does not depend on its ability to do so at a profit, any more than it does for the local telephone companies themselves. For both of these parties, signing up residential subscribers, at a loss, is feasible and attractive only because that gives them the first shot at obtaining the business that is priced far above cost. So what AT&T is demanding is an equal shot at the overpriced markets without having to bear any of the costs that justify that overpricing.

Consider what would happen, then, if the Baby Bells were forced to accede to AT&T's demand and charge it wholesale rates for those local loops sufficiently below cost to permit it to match the LECs' own non-compensatory rates for basic residential service. AT&T would then be able to undercut the artificially inflated prices that the Baby Bells' are forced to charge if they are to have a fair shot at recovering their total costs, without having to bear the burdens that justify that overpricing. And it would be able to take over what would undoubtedly be a large share of revenues from the overpriced services that, under the ages-old practice followed by AT&T itself before the breakup, made it possible to hold basic residential rates below economically efficient levels.

The solution is of course for regulators to get the basic residential service rates right and take care of poor people with direct subsidies, just as we do with food and medical care. Then we can leave it to fair and unbiased competition to take care of all the rest. Until that happens, what AT&T and the others are demanding is a free ticket of admission into the rich markets with the local companies paying for the ticket. As the old song put it, that's nice work if you can get it.

ALFRED E. KAHN
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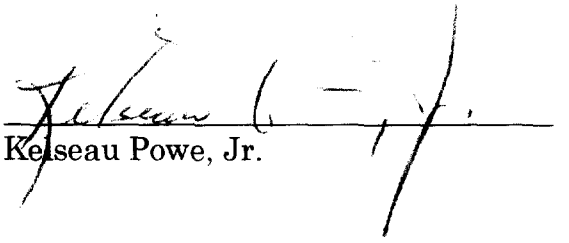
CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 11th day of January, 1996, I have caused a copy of the foregoing **REPLY OF U S WEST COMMUNICATIONS, INC.** to be served via first-class U.S. Mail, postage prepaid, upon the persons listed on the attached service list.



Kelseau Powe, Jr.

***Via Hand-Delivery**

(CC941E.COS/JH/lh)